SENATE FISCAL AGENCY

ELECTRIC INDUSTRY RESTRUCTURING IN MICHIGAN

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Introduction

The issue of deregulating or restructuring the electric industry has been the subject of review and debate within individual states and at the Federal level since the early to mid-1990s. To date, approximately half of the states, including Michigan, have taken legislative and/or administrative steps to restructure the electric industry within their jurisdictions, and legislation has been proposed in Congress.

While the subject of electricity restructuring may be familiar to legislators, policy-makers, businesses, and those in the electric industry, most individuals are not necessarily well versed on this topic or even aware of it. This article attempts to explain the concept and background of electricity restructuring, reviews legislation that Michigan recently enacted, and discusses issues that the legislation might not have completely addressed or did not resolve to the satisfaction of some people. Because of the subject's complexity and breadth, the article simply provides an overview for those unfamiliar with the issue.

Background

General. Traditionally, the provision of electricity has been considered a natural monopoly that is subject to governmental regulation. (A natural monopoly typically arises when one provider in a market can serve customers more efficiently than competing providers could do so.) The question that many states have been addressing is whether to transform this regulated monopoly into a competitive market that allows retail customers to choose their supplier. Though the process often is called "deregulation", which would remove virtually all governmental control of the industry or components of it, the term "restructuring" more accurately describes the steps that states have taken. As a rule, in a restructured environment, the providers of some services–particularly the generation of electricity–compete for retail customers and may or may not be subject to some degree of regulation, while the providers of other services--transmission and distribution of electricity--remain regulated monopolies.

Unless restructuring is implemented, electric utilities usually provide a "bundled" product; that is, they generate the electricity and transmit it to customers connected to power lines owned by the utilities. When the industry is restructured and customers are given a choice of providers--also referred to as "open access" and "retail wheeling", a utility's generation, transmission, and distribution services effectively are "unbundled". In order for customers to purchase electricity from third-party suppliers, those suppliers must have access to the utilities' transmission lines. Thus, when this takes place, the utilities are said to "wheel" the electricity across their power lines.

Although the electricity market has existed in its present structure for roughly 100 years, the concepts of customer choice and industry competition did not arise until recent years. This is because wheeling depends upon an interconnected transmission grid--the system of power lines that covers large sections of the United States. A push to integrate the system apparently came after New York City's blackout in 1965, when electricity could not travel long distances due to transmission limitations. In 1992, the Federal Energy Policy Act was enacted, allowing the Federal Energy Regulatory Commission to order wholesale wheeling, which involves electricity sold by one utility to another. At approximately the same time, people began to discuss retail wheeling, in which electricity is sold by one power generator over another company's lines to the final customer (also called the "end-user"). In addition, over the past few decades, advances in power generation technology have made small generating facilities more economically feasible.

There are various incentives for restructuring the electric industry. The ability of customers to choose providers and the existence of competition within a market can be considered goals in and of themselves. At the same time, restructuring is driven in large part by the need to generate additional electric power–both to support current needs and to promote economic development. According to a recent article in *TIME*, "Summer electricity demand in the U.S. has jumped 23% since 1992, while capacity has risen only 6%... [B]y one Energy Department estimate, the country needs 1,000 new plants in the next two decades" ("Power Surge", 7-17-00).

The article in *TIME* also reported that very few major new power plants have been built in the past 20 years. Although the need for additional generating capacity is not unexpected, electric utilities across the country have been facing the prospect of restructuring for at least the past five years. Because of the potential for competition, the amount of power utilities will have to provide in the future is uncertain. Depending upon the number of customers who choose to buy electricity from third-parties, or "alternative suppliers", the utilities' current generating capacity may be adequate or even excessive to serve their remaining customers.

In addition, the debate about "stranded costs" has made utilities cautious about making expensive new commitments. Stranded costs generally are capital investments that currently are paid for by customers but might not be collectible in the future if customers switch to other suppliers. Without assurance that they will be able to recover stranded costs incurred under the present regulatory framework, utilities have been reluctant to make significant expenditures or long-term commitments. At the same time, third parties that might be interested in building plants hesitate to do so when there is uncertainty about the opportunity to sell their product to retail customers.

The transmission of electricity is another important factor in restructuring. Although interconnected, the existing transmission grid was not built to support current demands or to wheel power from one region to another. Even if the total amount of electricity generated might be sufficient, it is not always feasible to get the power where it must go. The need to expand and upgrade the system apparently exists for either a regulated or a restructured industry.

Michigan. The background that led to restructuring in Michigan is essentially as described above. Within this State, there are approximately 60 electric utilities, including investor-owned utilities, municipally owned utilities, and rural cooperatives. The largest of the investor-owned utilities are Detroit Edison and Consumers Energy (referred to below as "Edison" and "Consumers", respectively). These two companies are responsible for approximately 90% of the State's generating capacity and nearly all of the transmission capacity. This natural monopoly evolved largely as a result of laws controlling the proliferation of power lines. In particular, under Public Act 69 of 1929, a public utility must prove to the Michigan Public Service Commission (PSC) that "public convenience and necessity" require the construction or operation of a plant, before the utility may build or operate one. This Act also requires the utility to secure "the necessary consent or franchise" from the municipality in which the plant is proposed.

The need for additional generating capacity exists in Michigan, as it does across the country. While the PSC recommends a reserve capacity of 15%, the current capacity, based on in-State generation, is less than 5%. In addition, many people believe that the price of electricity is too high in Michigan, particularly compared with neighboring states.

In January 1996, Governor Engler forwarded to the PSC recommendations from a Michigan Jobs Commission report. In part, the report suggested moving the electric industry in Michigan to a competitive market for the power supply component of electric service, while retaining transmission and distribution as functions of a regulated utility market. In the summer of 1996, the PSC held hearings across the State, seeking public input on the restructuring issue. A subsequent PSC Staff Report proposed implementing a system in which retail customers would have the opportunity to choose their power supplier.

Between 1997 and 1999, the PSC issued six orders to implement a customer choice program. The latest of those orders, issued in August 1999, followed a June 1999 Michigan Supreme Court decision that the Commission did not have the authority to mandate that utilities offer an experimental retail wheeling program. The order, issued on August 17, 1999, then gave Edison and Consumers the option of making an irrevocable election to implement a customer choice program. Although both Edison and Consumers had a choice program, this order was challenged in court.

Enacted Legislation

Michigan recently enacted a package of legislation to restructure the electric industry in this State. The principal measures are Public Acts 141 and 142 of 2000 (Senate Bills 937 and 1253), which took effect on June 5. Public Act 141 created the "Customer Choice and Electricity Reliability Act" to provide for the actual restructuring. Public

Act 142 permits the PSC, if certain conditions are met, to authorize an electric utility to issue "securitization" bonds that will pay for the utility's regulatory assets (e.g., capital expenditures). Also, Public Acts 155 and 156 (Senate Bills 940 and 941), which took effect on June 14, amended laws governing municipalities' sale of electric generation service.

Public Act 141 accomplishes the restructuring in a number of ways, including the following:

-- *Customer Choice:* The PSC must issue orders that allow all retail customers to choose an alternative electric supplier. Previous PSC choice orders (for Edison and Consumers) are validated, and the remaining utilities must file a restructuring plan allowing customer choice. The PSC must license alternative suppliers.
-- *Market Power Test*: A utility that controls over 30% of the generating capacity in the Upper or Lower Peninsula must take certain steps (such as selling a portion of that capacity) to meet the 30% limit.
-- *Transmission Divestiture:* Investor-owned utilities must either join a multistate transmission system organization or divest their interest in transmission facilities. (In effect, this separates utilities' generating and transmission services.)
-- *Transmission Connection*: Utilities must connect merchant plants (generating facilities not owned by a utility) to the utilities' transmission systems.
-- *Unbundling:* Utilities are required to unbundle their commercial and industrial rate schedules, and the PSC may order the unbundling of residential rates.
-- *Stranded Costs:* The PSC orders allowing customer choice must provide for full recovery of a utility's net stranded costs and implementation costs.

Public Act 141 also mandated a 5% reduction in the residential rates of Edison and Consumers that were in effect on May 1, 2000, and freezes those reduced rates and the utilities' other rates through 2003. The frozen rates may not be increased or decreased during this period (although any savings resulting from securitization must be used to reduce retail rates). After 2003, the utilities' rates may not be increased until 2014 or until the market power test is met.

In addition, Public Act 141 requires utilities serving over 100,000 retail customers to file a joint plan to expand transmission capability by at least 2,000 megawatts; allows the use of aggregation for the purchase of electricity from alternative suppliers; requires the PSC to establish a code of conduct applicable to electric utilities and alternative suppliers; establishes penalties for violations, including the practice of "slamming" (switching a customer's supplier without authorization); imposes conditions on municipal utilities that choose to provide generation service to customers receiving transmission or distribution from an electric utility; and provides for cooperative utilities to allow choice and unbundle rates. The Act also contains worker protection provisions that apply upon the transfer or sale of a utility's divisions or units; prohibits utilities from shutting off service to eligible customers; and requires utilities and suppliers to inform customers about the availability of alternative suppliers and the environmental characteristics of electricity purchased.

The securitization provisions in Public Act 142 require the PSC to issue a "financing order" that authorizes a utility to issue bonds, notes, or other types of indebtedness, for the recovery of "qualified costs". Qualified costs include "regulatory assets" (e.g., capital expenditures such as nuclear plants, and other incurred obligations whose recovery has been delayed, such as pension benefits), and other costs the utility would not be able to recover in a competitive market. The bonds are to be repaid from a "nonbypassable charge" imposed on the utility's customers, regardless of whether they choose another electricity supplier. The PSC must issue a financing order only if standards in the Act are met and the revenue to be collected under the order is less than the amount that otherwise would be recovered.

(A detailed description of the legislation, and an analysis of its potential fiscal impact, will be available in an Enrolled Summary of Senate Bills 937, 940, 941, and 1253 at http://michiganlegislature.org/.)

Remaining Issues

Perhaps the foremost question is whether Michigan's restructuring legislation actually will produce a competitive electric industry and new generating plants within the State. Some people claim that the legislation will neither foster competition nor reduce rates. Some contend that the market power test, as enacted, will fail to encourage

the two major utilities to divest, and the rate freeze and cap will create an incentive for customers to remain with their incumbent utility. In addition, controversy already has arisen over actions the PSC has taken in response to the legislation, as well as costs that have been included in applications for securitization.

If competition does result, according to some people, it will benefit only large, industrial customers. Although utilities must give all customers the option of choosing their supplier, alternative suppliers might not market their services to residential or rural customers, or small businesses, if doing so is not cost-effective.

Many people also believe that the legislation should have taken greater steps to assist the low income population and promote weatherization. Public Act 141 does provide for a Low-Income and Energy Efficiency Fund, but the liquidity of that Fund will depend on savings resulting from securitization. The Act also codifies shut-off protections for eligible customers, but requires a customer to demonstrate that he or she has applied for governmental heating assistance (even though relatively few people heat their homes with electricity). The proponents of increased protections advocated a "system benefit charge" that would fund these programs and offset the fluctuations of Federal funding. Public Act 141 requires the PSC to monitor the availability of Federal funds, and hold a hearing and report to the Legislature if Federal funding declines.

Another area of dissatisfaction involves environmental concerns. Public Act 141 requires suppliers to inform their customers about the environmental characteristics of electricity purchased, including fuel sources and emissions. Some people believe, however, that suppliers should be required to derive a certain percentage of their electricity from clean energy sources or make a payment to a renewable resources development fund (as some states apparently require). It also has been suggested that reduced rates might lower the incentive for utilities and customers to invest in alternative energy technologies, and that aggressive marketing might produce increased energy consumption.

In addition to requiring the disclosure of environmental characteristics, Public Act 141 requires the PSC to establish the Michigan Renewable Energy Program, and provides that the Act does not limit self-service power (which may encourage people to build renewable power facilities). While these are considered important environmental provisions, it has been pointed out that they must be fully implemented in order to be effective.

The issue of cross-subsidization also may not have been addressed to everyone's satisfaction. Unlike previous versions of the legislation, which included detailed cross-subsidization provisions, Public Act 141 simply requires the PSC to adopt a code of conduct that includes measures to prevent cross-subsidization, information sharing, and preferential treatment between a utility's regulated services (e.g., electricity sales) and unregulated services (such as appliance repair). Without adequate safeguards, cross-subsidization potentially can threaten small, independent businesses.

Despite some people's concerns, Public Act 141 does not address net metering. This refers to the measurement of electricity generated at an industrial, commercial, or residential site versus the amount of electricity supplied to that site by a utility or alternative supplier. Net metering allows these customers to be billed only for their net energy consumption, and gives them credits for months in which they generate more than they use. Reportedly, 29 other states (including 21 involved in restructuring) provide for net metering. Proponents claim that it encourages the development of small-scale renewable energy-generating facilities, while returning electricity to the system.

Another issue not addressed by the legislation (with one exception) involves franchises, which must be obtained from every local unit of government in which a business wishes to operate. The process of getting a franchise is said to be cumbersome, time-consuming, and costly, particularly when a number of local units are involved, and reportedly can be a barrier to entering the market. Instead of requiring multiple local franchises, it has been suggested that the State should issue one license to businesses that merely pass electricity through existing power lines. As already noted, Public Act 141 does not address this issue. Except in regard to aggregated school districts (which need not obtain a franchise), the Act also leaves open the question of whether alternative suppliers or aggregators are subject to the law's franchise requirement.

In addition, it is not clear whether the rates charged by alternative suppliers are subject to regulation by the PSC. Neither the licensing provisions of the Act, nor the licensing procedures ordered by the PSC, require alternative

suppliers to submit rate filings, as electric utilities must do. The resolution of this issue (and others) ultimately may rest upon a judicial interpretation of the relevant statutes.

Though neither detailed nor exhaustive, this discussion demonstrates that the enacted legislation is a compromise in many respects, and that various issues are likely to be revisited. Although State regulators and those in the industry are actively responding to the legislation and its implementation, it is unclear how individual customers will react. Given their experience with telephone deregulation, it is entirely possible that consumer response will be less than enthusiastic. This may be compounded by the complexity of the issue. For example, while buying power from an environmentally friendly source may be important to many consumers, they might not realize that their electricity will not come directly from the "green" supplier they choose; rather, the power generated by that supplier simply will contribute to the entire pool of electricity generated throughout the country.

It is likely that the results of restructuring in Michigan will not be known for years to come. While the rates of most consumers are frozen through 2003 and will be capped for a time beyond that (if the customers stay with Edison and Consumers), there are a number of variables that may directly or indirectly affect what individuals and businesses pay for electricity and the degree to which they have a choice of provider. These factors include, but are not limited to, the calculation of stranded costs and implementation costs, the determination of a utility's market control, the costs allowed under a financing order, the amount of securitization charges imposed on customers, and the willingness of third-party providers to enter the market in Michigan.